

approve or disapprove of a certain practice, "[r]ecognized standards of *business ethics* and business customs and practices are pertinent" in determining whether interference with a contract was improper

Moreover, as the Advisory Group and Commission recognized, Congress and regulators have been even more than willing to prescribe at least some focus on ethics within organizations. For example, codes of ethics for senior executives of publicly traded companies are now essentially mandated by law and regulation, and Nasdaq and NYSE-listed companies must have codes of ethics for all employees.

In addition, the Department of Health and Human Services Office of Inspector General requires pharmaceutical manufacturers have written policies and procedures and recommends that they "develop a general corporate statement of ethical and compliance principles that will guide company operations." *OIG Compliance Program Guidance for Pharmaceutical Manufacturers*, Office of Inspector General, Department of Health and Human Services, Fed. Reg. Vol. 68, No. 86, 23731 at 23733 (May 5, 2003).

And lately, responding to the sense of frustration felt by the public, even the courts have willingly entered the ethics debate, indicating a fundamental shift in the manner in which they view ethics as part of the judicial process. This has manifested itself in several ways. First, as a greater emphasis on ethics in analysis, including in *U.S. v. Andreas*, 216 F.3d 645, (7th Cir. 2000) and *Haberman v. S.E.C.*, 205 F.3d 1345 (8th Cir. 2000) (unpublished disposition).

This is not to say that there should be no limitations on the courts' ability to assess ethical standards and conduct. The point of judicial analysis of an organization's commitment to ethics and law should be to assess whether the organization has effectively promoted them and not whether they have achieved some standardized culture of ethical and legal compliance. That is, courts should not assess *how ethical* an organization is, but *how hard* it has tried.

Moreover, we believe that there is little risk that a court would choose to engage in the exercise of assessing an organization's ethics. This is especially so when the principles applicable at law (*i.e.*, the Chapter 8 guidelines) provide ample guidance toward the appropriate analysis: whether the organization has effectively *promoted* a culture of ethics and compliance. Indeed, as recently as last October, Judge Pollack declined to engage in the exercise of assessing an organization's ethical behavior, stating that "[t]he plaintiffs in the above-captioned putative class actions would have this Court punish breaches of business ethics by principles applicable at law which did not at the time apply to such conduct." However, the implication is that, had such "principles applicable at law" applied at the time, Judge Pollack would have engaged in the appropriate analysis. *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*, 289 F.Supp.2d 416, 418 (SDNY. 2003).

And perhaps most remarkable to date has been the recent landmark settlement response – with the enforceability of the court's permanent injunction – to one of the largest securities frauds ever to occur in the United States. In *SEC v. Worldcom*, Judge Rakoff noted:

[2-140]

The permanent injunction also requires the company to provide a large segment of its employees with specialized training in accounting principles, public reporting obligations, and *business ethics*, in accordance with programs being specially developed for the company by New York University and the University of Virginia. At the behest of the Corporate Monitor, the Court also obtained from the new Chief Executive Officer a sworn "*Ethics Pledge*," requiring, on pain of dismissal, a degree of transparency well beyond S.E.C. requirements. The company has since required its senior management to sign a similar pledge, and has plans to obtain similar pledges from virtually all employees.

S.E.C. v. Worldcom, Inc., 273 F.Supp.2d 431, S.D.N.Y.,2003 (emphasis added).

In sum it is our considered opinion that as long as the guidelines focus on compliance and do not explicitly include an ethical component, the discussion will remain about that which is required to do and not that which is right to do. A more prudent course, and one more consistent with the activities of the other branches of government and of industry itself, is to foster a culture based on both compliance and ethics. Only in that way will we help build a system in which both compliance and virtue are their own rewards.

Consequently, we believe the Commission should make the following changes to the proposed amendments:

§8B2.1(a)(2)

"otherwise promote an organizational culture that encourages a commitment to ethics and the law."

§8B2.1(b)

"Due diligence and the promotion of an organizational culture that encourages a commitment to ethics and compliance with the law."

§8B2.1(b)(1)

"The organization shall establish ethics and compliance standards and procedures to prevent and detect violations of law."

LRN would like to again thank the Commission for this opportunity. We hope that our comments will help inform the Commission's considerations.

[2-141]



S O U T H E R N
M E T H O D I S T
U N I V E R S I T Y .

Maguire Center for Ethics and Public Responsibility

February 13, 2004

The Honorable Judge Diana M. Murphy, Chair
U.S. Sentencing Commission
One Columbus Circle NE, Suite 2-500
Washington DC 20002-8002

Dear Judge Murphy,

I have read Robert Olson, Stuart Gilman, and Michael Hoffman's thoughtful letter, bill mark-up, and justification with respect to proposed amendments to the FSGO. They deserve your most careful reading and consideration.

It is vital to address the authors' recommendation that Guidelines stress society's aspirations for a supportive organizational culture and good ethical environment, beyond mere compliance. The founding fathers recognized this. We should too. This amendment must set noble goals as well as legalistic minimums.

Thank you for your time and consideration.

Sincerely,

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Michael Hoffman, PhD, Executive Director

[2-142]

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January 28, 2004

The Honorable Jude Diana M. Murphy, Chair
U.S. Sentencing Commission
One Columbus Circle NE, Suite 2-500
Washington DC 20002-8002

Dear Judge Murphy,

We congratulate you, your fellow commissioners, and your staff for drafting the Proposed Amendments and making them available for public comment. We know that the process has involved considerable time and resources. The result, however, has been amendments to the Guidelines that will make them more relevant to the new millennium.

Yet we're concerned that they are not as germane and significant as they could be. Indeed, if the goal was to go "beyond compliance," they disappoint by not going as far as numerous other governmental bodies, such as the SEC and Congress, have done already. As they stand now, the Proposed Amendments:

- fail to support the integration of "ethics" into compliance programs,
- sidestep an opportunity to re-define "effectiveness" in a substantive way, and
- neglect to reconsider the purview of an ethics and compliance program in the current environment of corporate malfeasance.

In our opinion, the Proposed Amendments need to reflect the proposition that ethics is the heart of law

We respectfully offer our suggested changes to the Proposed Amendments with an accompanying justification (please see enclosures). It is our hope that you will consider them in the spirit in which they are offered—a mutual concern for enhancing the public good. We will also be contacting members of Congress in the same spirit. If there's anything we can do to assist the Commission in further understanding these suggested changes—or obtaining documents in support of them—please do not hesitate to contact us.

This process for amending the Federal Sentencing Guidelines for Organizations presents an exciting opportunity, one that will probably not come again for another ten years. We urge the Sentencing Commission to retain its *leadership role* in preventing corporate malfeasance by including the changes we've suggested in the final amendments.

Sincerely,

[signature on file]

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[2-143]

**PART B – REMEDYING HARM FROM CRIMINAL CONDUCT, AND
PREVENTING AND DETECTING VIOLATIONS OF THE LAW**

1. REMEDYING HARM FROM CRIMINAL CONDUCT

* * *

2. PREVENTING AND DETECTING VIOLATIONS OF LAW

§8B2.1 Effective Programs to Prevent and Detect Violations of Law

(a) To have an effective program to prevent and detect violations of law, for purposed of subsection (f) of §8C2.5 (Culpability Score) and subsection (c)(1) of §8D1.4 (Recommended Conditions of Probation – Organizations), an organization shall—

- (1) Exercise due diligence to prevent and detect violations of law; and
- (2) otherwise promote and organizational culture that encourages a commitment to the ethical principles that inform compliance with law

Such program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting violations of law, as well as promoting an organizaitonal culture committed to ethical principles, that is, one that demonstrates commitment to ethical principles and compliance with law. The failure to prevent or detect instant offense leading to sentencing does not necessarily mean that the program is not generally effective in preventing and detecting violations of law, as well as in promoting an organizational culture committed to ethical principles.

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with law and the ethical principles that inform law within the meaning of subsection (a) minimally require the following steps:

- (1) The organization shall establish ethics and compliance standards and procedures to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles.
- (2) The organizational leadership shall be knowledgeable about the content and operation, and effectiveness of the program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles.

[2 - 144]

The organization's governing authority shall be knowledgeable about the content, and operation, and effectiveness of the program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles, and shall exercise reasonable oversight with respect to the implementation and effectiveness of the program to prevent and detect violations of the law, as well as to promote an organizational culture committed to ethical principles.

Specific individual(s) within high executive-level personnel of the organization shall be assigned direct, full-time, overall responsibility to ensure implementation and effectiveness of the program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles. Such individual(s) shall be given adequate resources and authority to carry out such responsibility, including full participation in all major executive decisions, and shall report on the implementation and effectiveness of the program to prevent and detect violations of law, as well as in promoting an organizational culture committed to ethical principles, directly to the governing authority or an appropriate subgroup of the governing authority.

(3) The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through exercise of due diligence, has a history of engaging in violations of law or other conduct inconsistent with an effective program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles.

(4)(A) The organization shall take reasonable steps to institutionalize its ethics and compliance program by

(i) using model practices in organizational and systems change and

(ii) communicating, communicate in a practical manner its ethics and compliance standards and procedures, and other aspects of the program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles, to the individuals referred to in subdivision (B) by conducting effective training programs that include but are not limited to subjects such as ethical and legal decision making, and otherwise disseminating information, appropriate to such individual's respective roles and responsibilities, with special emphasis on the organization's executive team.

[2-145]

(B) The individuals referred to in subdivision (A) are the members of the governing authority, the organizational leadership, the organization's employees, and, as appropriate, the organization's agents.

(5) The organization shall take reasonable steps—

(A) to ensure that the organization's program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles, is followed, including use of monitoring and auditing systems that

(i) are designed to prevent and detect violations of law and ethical principles that inform law, and

(ii) function at all levels and in all functions of the organization, including, but not limited to, the executive and governing authority level;

(B) to evaluate at least annually periodically the effectiveness of the organization's program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles; and

(C) to have a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual violations of law without fear of retaliation, including mechanisms to allow for anonymous reporting.

(6) The organization's program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles, shall be promoted and enforced consistently through appropriate incentives, such as including compliance with law and commitment to ethical principles as a major component in performance reviews, to perform in accordance with such program and disciplinary measures for engaging in violations of law and for failing to take reasonable steps to prevent or detect violations of law, as well as to promote an organizational culture committed to ethical principles.

(7) After a violation of law or ethical principles that inform law has been detected, the organization shall take reasonable steps to respond appropriately to the violation of law or ethical principles that inform law and to prevent further similar violations of law or ethical principles that inform law, including making any necessary modifications to the organization's program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles, and to the organization's business practices, as necessary.

[2-146]

- (a) In implementing subsection (b), the organization shall conduct at least annually ongoing risk assessment and take appropriate steps to design, implement, or modify each step set for the in subsection (b) to reduce violations of law or ethical principles that inform law identified by the risk assessment.

Commentary

Application Notes:

1. Definitions. For purposes of this guideline:

“Ethics and Compliance standards and procedures” means standards of conduct such as a code of ethics or statement of values, and internal control systems that are reasonably capable of reducing the likelihood of violations of law and ethical principles that inform law.

“Governing authority” means (A) the Board of Directors, or (B) if the organization does not have a Board of Directors, the highest level governing body of the organization.

“Organizational leadership” means (A) executive high-level personnel of the organization; (B) executive high-level personnel of a unit of the organization; and (C) substantial authority personnel. The terms “executive high-level personnel of the organization” and “substantial authority personnel” have the meaning given those terms in the Commentary to §8A1.2 (Application Instructions – Organizations). The term “executive executive-level personnel of a unit of the organization” has the meaning given that term in the Commentary to §8C2.5 (Culpability Score).

“Effective” means not only the count resulting from specific program activities, but also (A) the impact (measured changes in knowledge, attitudes/values/beliefs, and/or short-term practice) of those activities and (B) the outcome of those activities (actual reductions in violations of law or ethical principles that inform law—or well-documented proxies for those violations).

Except as provided in Application Note 4(A), “violations of law” means violations of any law, criminal or noncriminal (including a regulation), for which the organization is, or would be, liable.

2. Factors to Consider in Meeting Requirements of Subsections (a) and (b).—

(A) In General.—Each of the requirements set forth in subsections (a) and (b) shall be met by an organization; however, in determining what specific actions are necessary to meet those requirements, the organization shall consider factors that include (i) the size of the organization, (ii) applicable government regulations,

[2-147]

and (iii) any ethics and compliance practices and procedures that are well-documented generally accepted as standard or model practices for businesses similar to the organization.

(B) The Size of the Organization.—

- (i) In General.—The formality and scope of actions that an organization shall take to meet the requirements of subsections (a) and (b), including the necessary features of the organization's ethics and compliance standards and procedures, depend on the size of the organization. A larger organization generally shall devote more formal operations and greater resources in meeting such requirements than shall a smaller organization.
- (ii) Small Organizations.—In meeting the requirements set forth in subsections (a) and (b), small organizations shall demonstrate the same degree of commitment to compliance with the law and commitment to ethical principles that inform law, as larger organizations, although generally with less formality and fewer resources than would be expected of larger organizations.

1. Application of Subsection (b)(2).—

- (A) Governing Authority.—The responsibility of the governing authority under subsection (b)(2) is to exercise reasonable oversight of the organization's efforts to ensure compliance with the law and ethical principles that inform law. In large organizations, the governing authority likely will discharge this responsibility through oversight, whereas in some organizations, particularly small ones, it may be more appropriate for the governing authority to discharge this responsibility by directly managing the organization's ethics and compliance efforts.
- (B) Executive/High-Level Personnel.—The organization has discretion to delineate the activities and roles of the specific individual(s) within executive high-level personnel of the organization assigned overall and direct responsibility to ensure the effectiveness and operation of the program to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles; however, the individual(s) must be able to carry out their overall and direct responsibility consistent with subsection (b)(2), including the ability to report on the effectiveness and operation of the program to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles; to the governing authority, or to an appropriate subgroup of the governing authority.

In addition to receiving reports from the foregoing individual(s), the governing authority or an appropriate subgroup thereof typically should receive at least

annually periodically information on the implementation and effectiveness of the program to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles, from the individual(s) with day-to-day operational responsibility for the program.

(C) Organizational Leadership.—Although the overall and direct responsibility to ensure the effectiveness and operation of the program to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles, is assigned to specific individuals within executive high-level personnel of the organization, it is incumbent upon all individuals within the organizational leadership to be knowledgeable about the content, and operation and effectiveness of the program to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles, pursuant to subsection (b)(2), and to perform their assigned duties consistent with the exercise of due diligence, and the promotion of an organizational culture that encourages a commitment to ethical principles that inform the compliance with the law, under subsection (a).

1. Application of Subsection (b)(3).—

(A) Violations of Law.—Notwithstanding Application Note 1, “violations of law,” for purposes of subsection (b)(3), means any official determination of a violation or violations of any law, whether criminal or noncriminal (including a regulation).

(B) Consistency with Other Law.—Nothing in subsection (b)(3) is intended to require conduct inconsistent with any Federal, State, or local law, including any law governing employment or hiring practices.

(C) Implementation.—In implementing subsection (b)(3), the organization shall hire and promote individuals consistent with Application Note 3(C) so as to ensure that all individuals with the organizational leadership will perform their assigned duties with the exercise of due diligence; and the promotion of an organizational culture that encourages a commitment to ethical principles that inform law compliance with the law, under subsection (a). With respect to the hiring or promotion of any specific individual within the substantial authority personnel of the organization, an organization shall consider factors such as: (i) the individual's combined academic and certificated training in ethics and/or law, as well as training in organizational change strategies and behavioral training methodologies; (ii) the recency of the individual's violations of law and other misconduct (i.e., the individual's other conduct inconsistent with an effective program to prevent and detect violations of law, as well as to promote an organizational culture committed to ethical principles); (iii) the relatedness of the individual's violations of law and other misconduct to the specific responsibilities the individual is anticipated to be assigned as part of the substantial authority personnel of the organization; and (iii) whether the individual has engaged in a pattern of such violations of law and other misconduct.

[2-149]

1. Risk Assessments under Subsection(c).—Risk assessments required under subsection (c) shall include the following:

(A) Assessing periodically the risk that violations of law or commitment to ethical principles that inform law will occur, including an assessment of the following:

(i) The nature and seriousness of such violations of law.

(ii) The likelihood that certain violations of law or commitment to ethical principles that inform law may occur because of the nature of the organization's business. If, because of the nature of an organization's business, there is a substantial risk that certain types of violations of law or ethical principles that inform law may occur, the organization shall take reasonable steps to prevent and detect those types of violations of law or ethical principles that inform law. For example, an organization that, due to the nature of its business, handles toxic substances shall establish ethics and compliance standards and procedures designed to ensure that those substances are always handled properly. An organization that, due to the nature of its business, employs sales personnel who have flexibility to set prices shall establish ethics and compliance standards and procedures designed to prevent and detect price-fixing. An organization that, due to the nature of its business, employs sales personnel who have the flexibility to represent the material characteristics of a product shall establish ethics and compliance standards and procedures designed to prevent fraud. Furthermore, an organization shall establish ethics and compliance standards and procedures designed to prevent corporate malfeasance that may result from the decisions of executive management and governing authority.

(iii) The prior history of an organization. The prior history of an organization may indicate types of violations of law or ethical principles that inform law that it shall take actions to prevent and detect. Recurrence of similar violations of law or ethical principles that inform law creates doubt regarding whether the organization took reasonable steps to prevent and detect violations of law or ethical principles that inform the law.

(B) Prioritizing, periodically as appropriate, the actions taken under each step set forth in subsection (b), in order to focus on preventing and detecting the violations of law or ethical principles that inform law identified under subdivision (A) as most likely to occur and most serious.

(C) Modifying, as appropriate, the actions taken under any step set forth in subsection (b) to reduce the risk of violations of law or ethical principles that inform law identified in the risk assessment.

(D) Assessing at least annually one or more of these characteristics of organizational culture: executive decision making process, impact and/or outcome of this process through use of an "ethics impact report," level of organizational trust, public image, relative disparity in employee compensation, bottom-line mentality and others that are well-documented in the literature.

Background: This section sets forth the requirements for an effective program to prevent and detect violations of law. This section responds to section 805(a)(2)(5) of the Sarbanes-Oxley Act of 2002, Public Law 107-204, which directed the Commission to review and amend, as appropriate, the guidelines and related policy statements to ensure that the guidelines that apply to organizations in this Chapter "are sufficient to deter and punish organizational criminal misconduct."

The requirements set forth in this guideline are intended to achieve reasonable prevention and detection of violations of law, both criminal and noncriminal, for which the organization would be vicariously liable, as well as to promote an organizational culture committed to ethical principles. The prior diligence of an organization in seeking to detect and prevent violations of law, as well as to promote an organizational culture committed to ethical principles, has a direct bearing on the appropriate penalties and probation for the organization if it is convicted and sentenced for a criminal offense.

* * *

[2-151]

JUSTIFICATION

for

Suggested Changes to Proposed Amendments to FSGO

It is questionable whether a compliance program can be truly effective if it does not have an ethics component.

- - - Diana E. Murphy^y

The changes we have suggested to the Proposed Amendments to the FSGO can be divided into three general categories: Omission of Ethics, Expansion of Ethics and Compliance Program Purview, and Measurement of Program Effectiveness. For each of these categories, we will provide a justification for the suggested changes.

Omission of Ethics

There is no mention of “ethics” in the Proposed Amendments *even though*

- ethics was discussed extensively in the Advisory Group’s Recommendations for Proposed Amendments, primarily in relation to the new developments in the arenas of compliance, ethics, and corporate governance with which the Advisory Group was trying to “synchronize” its recommendations (though *not* in the amendments and commentary it actually recommended);
- ethics figures largely in the “new developments” mentioned by the Advisory Group. For example, the SEC, Sarbanes-Oxley Act of 2002, and the NYSE all encourage or require their constituents to move beyond a compliance-based program to an ethics/values/integrity-based program for the prevention of fraud, waste, and abuse. In addition, the FASB has recently proposed a rule that would change its approach from rule-based to principle-based. All of these “new developments,” although they preceded the Proposed Amendments, are bolder, more innovative, and consistent with best practices, than the Proposed Amendments;
- ethics is the real tenor of “organizational culture” as enunciated in the Proposed Amendments. The concept of “organizational culture” that is apparently substituted for “ethics” simply begs the question of how an organization gets “beyond compliance” and how it measures whether its culture “promotes compliance with law.” An organization can strengthen its compliance program by enforcing more compliance with law ever more rigorously (and penalties for noncompliance), but in doing so it risks turning itself into a police state. Alternatively, it can situate compliance in ethics inasmuch as the laws that are the object of compliance are already grounded in ethical principles. To do otherwise only reinforces what William Widen in a recent article in *The Business Lawyer* refers to as “technical compliance”ⁱ—or the Office of the Inspector General calls a “paper program”;
- ethics is no more “fuzzy” than the law. Both require interpretation, ethics within the organization as business decisions are made, and law in the judicial system by attorneys (and at much greater cost to the organization and public). Furthermore, the reluctance to refer to ethics in the Proposed Amendments seems to be based, in part, on the mistaken notion that by doing so they obviate the need for “...prosecutors to litigate and judges to determine whether an organization has a ‘good set of values’ or ‘appropriate ethical standards.’”ⁱ This is simply not the case. Prosecutors and judges would still have to make a separate determination about the effectiveness of the organizational culture in

[2-152]